February 5, 2008

AGENDA ITEM ________

REQUEST

CONDUCT A WORKSHOP TO REVIEW:

- **THE FY 07-08 BUDGET AT MID-YEAR**
- **PRELIMINARY BUDGET FIGURES FOR FY 08-09 AND BEYOND**
- **SHORT AND LONG TERM FISCAL STRATEGIES TO ADDRESS THE CITY'S STRUCTURAL BUDGET DEFICIT**

EXECUTIVE SUMMARY

The FY 07-08 Mid-Year Budget Workshop focuses on a review of the FY 07-08 budget at mid-year, FY 08-09 budget estimates, and a review of potential short and longer term fiscal strategies to address the City's structural budget deficit.

DISCUSSION

Budget and financial information in this report will be presented at the workshop. The information is in four major areas.

1. Background and the Current Economic Environment
2. General Fund Review at Mid-Year for the FY 07-08 Budget
3. Three year projection of General Fund Budgets (FY 08-09 – FY 10-11)
4. Consideration of short and long term fiscal strategy to address the City's structural budget deficit

1. Background and the Current Economic Environment

The City has benefited from strong growth in its revenues for well over a decade. For example, from 1999 to 2006 the City had annual sales tax revenue growth of 12.4% per year. Property tax during the period grew 15.1% per year on average. This has quickly changed however, in that Sales tax in FY 07-08 will decrease by 6% from the previous year and property tax will decrease by 2%.

Several years ago, the City anticipated that the growth experienced over the last decade would not continue in future years. The City took several actions to address future economic uncertainty anticipating that Measure A would have an impact on residential growth in the City with few single family building permits issued in 06-07 through approximately 2012. In preparation for this decline in revenue, the City created a special reserve fund (Reserve for Economic Uncertainty Fund).

The combination of increased labor costs for existing services, costs of providing additional new positions (Kirchhoff studies), and costs associated with operating new programs and facilities coupled with the slow down in revenues has resulted in a *structural* budget deficit for the General Fund.

While the City took responsible measures to build reserves, the significant housing and real estate market decline has created an additional layer of concern that will have a significant negative impact on the financial condition of the City over the next several years.

The following current events are critical factors impacting the economic environment:

- San Joaquin County, Stanislaus County and Merced County are the top three counties in the country for home foreclosures
- Home prices are expected to remain flat for several years as there are more sub-prime mortgages scheduled to reset in June 2008 resulting in less property tax to cities and counties
- Economists project there is 50% chance of a recession in 2008
- Spin off effects of the real estate market are being felt across industries. For Tracy this has resulted in a decline in sales tax
- The County Assessor has warned cities that property tax revenue will be flat or fall due to declining home prices (valuation)
- Neighboring cities have already experienced significant impacts to their bottom line and are taking serious measures to address their budget deficits

Consideration of these key economic factors affecting our revenues is critical in order to understand economic uncertainties faced by the City and prior to discussing future funding allocations.

2. General Fund Review at Mid-Year

The following is a comparison of the FY 07-08 General Fund adopted budget compared to the most recent estimate as of mid-year of FY 07-08.

	FY 07-08 Budget	Mid-Year Estimate
Beginning Fund Balance	$19,987,090	$19,111,270
Revenues exclusive of transfer in	$48,658,380	$46,821,130
Transfers in (Economic Uncertainty)	$ 5,733,000	$ 5,733,000
Expenses	-$54,391,330	-$52,713,618
Ending Fund Balance	$19,987,140	$18,951,782

Because in FY 07-08 it was anticipated that expenses would be greater than revenues, a draw on reserves from the Economic Uncertainty fund in the amount of $5,733,000 would be needed. Full detail of budget estimates can be found in Attachment A.

Revenues: Revenue estimates are expected to be $3 million lower than budget due to lower property taxes ($500,000 less), lower sales taxes ($1.1 million less), and lower revenues in a variety of revenue categories ($1.5 million less). Reductions in property tax and sales tax estimates are the result of the current economic conditions being estimates is in addition to the structural budget deficit of $5.7 million. However, it is anticipated the City will receive a one time accounting adjustment of $1.5 million in increased investment earnings (GASB 31) due to increased market valuation of current City investments. This one time positive adjustment is only expected for FY 07-08 and will not be recurring.

This $3 million estimated reduction in revenues together with the adopted budget deficit of $5.7 million would mean revenues for FY 07-08 would be $8.7 million less than budgeted expenses. This is partially offset by the GASB 31 adjustments applied.

Expenses: Expenses are estimated to be approximately $1.7 million lower than budget this fiscal year, primarily due to typical vacancy rates of approximately 5% in City jobs. It is estimated FY 07-08 expenses will be $52,713,618 rather than the originally budgeted amount of $54,391,330.

Fund Balance: The General Fund balance as of 6/30/08 is estimated to be $18,951,782, a drop of $1 million from FY 07-08 budget estimates. While it was anticipated in the FY 07-08 budget message that typical budget savings might reduce the actual draw on reserves, such budget savings have been offset by less revenue than was budgeted. Therefore a draw on the Reserve for Economic Uncertainty fund in the amount of $5.7 million will be needed thereby drawing down this fund balance from $19 million to approximately $13.3 million.

3. Three Year Projection of General Fund Budgets

The City uses a base budget model. This means the cost of continuation of existing services is calculated in order to determine the amount necessary to provide those services in the upcoming year. Actual expenses are reviewed from previous years, with an inflation factor and any other known increase in costs such as labor rates (i.e. labor contracts). The base budget is then calculated.

Without adding any programs or increasing services, the General Fund base budget for FY 08-09 expenditures are estimated to be $56,927,630. These base budget estimates do include the MCYSN program funded at $1 million, current operational funding for the Grand Theatre, Kirchhoff approved recommendations, and Council approved labor contracts along with other FY 07-08 base services. Revenues for FY 08-09 are estimated to be just $47,279,230 – virtually flat from FY 07-08. This results in a FY 08-09 budget deficit of $9,648,400. This budget funds the continuation of current services without the addition of any budget augmentations. Augmentations are increases to the base budget to expand services, add new programs, or add additional full time staff.

Below is base budget information estimated for the next 3 years in order to demonstrate the problem of a continued structural deficit and how this will affect reserves.

	FY 08-09	FY 09-10	FY 10-11
Beg. G.F. Bal.	$18,951,780	$18,951,780	$11,005,077
Beg E.U.Fund Bal.	$13,300,000	$ 3,651,600	$0
Revenues	$47,279,230	$47,846,500	$48,749,400
Expenses	$56,927,630	$59,444,803	$62,374,263
Deficit	$ 9,648,400	$11,598,303	$13,624,863
Ending G.F. Bal	$18,951,780	$11,005,077	($2,619,786)
Ending E.U. Fund Bal.	$ 3,651,600	$0	$0

The above illustrates that a structural budget deficit at the current base budget can only be sustained for 2 fiscal years with reserves from both the General Fund ($18.9 million) and from the Reserve for Economic Uncertainty fund ($13.3 million). By FY 10-11 the City would have expended all of these reserves and be over expended by $2.6 million with no reserves.

In 1990-91, a similar housing market decline affected Tracy and the rest of California. A review of the property tax and sales tax data (see chart below) showed that property tax increased the first year, but was essentially flat for three years before climbing. Sales tax revenues were impacted earlier, with a decline in sales tax the next year, but also an earlier recovery in the following fiscal year. While there are significant differences between the 1990-91 recession and the current economic situation, we expect property tax to behave similarly, with a delay in the impact, with a longer recovery time. We expect sales tax to recover sooner, however with increasing retail competition from other communities; the recovery may not be as robust as in 90-91.

	FY88-89	FY89-90	FY90-91	FY91-92	FY92-93	FY93-94
Property Tax	$2,295,047	$2,798,779	$3,545,389	$3,999,515	$3,944,625	$4,067,714
Sales Tax	$1,994,746	$2,314,591	$2,379,017	$2,213,747	$2,478,392	$2,598,885

It is likely City revenues will not rebound like they did in 90-91 for either property tax or sales tax. Even if the real estate market improved tomorrow, because of Measure A (which did not exist in 90-91) virtually no new homes can be constructed. As such, property tax will not rebound as before. Conditions today for sales tax growth are also not what they were in 90-91. Residential construction gave birth to new commercial investment in the community. The recent Gruen and Gruen Economic Report noted that "because of Measure A growth restrictions, that typical commercial development will be limited as those making such investment look for growth potential". This will lead to further sales tax competition with surrounding communities.

4. Short and Long Term Strategy to Address the City's Structural Budget Deficit

In light of the current economic conditions facing cities, counties and the State of California, it is important to develop a fiscal strategy for the coming years. When dealing with a structural budget deficit, every action taken today has a beneficial ripple effect in years to come. As a result steps taken today can be less draconian but have great impact in future years. Without action taken at present will mean far more draconian actions necessary later.

A fiscal strategy would cover both assumptions and actions. Assumptions guide the development of estimates for revenues and expenditures and other budgetary projections. Hence, more optimistic assumptions would result in greater revenues which in turn would require fewer actions to keep budgets balanced. Actions are steps that can be taken or policies that can be followed in order to set the City on a course of fiscal sustainability. Actions can be short term and long term.

<u>Assumptions</u>: The following are recommended fiscal strategy assumptions:

- Inflation and cost of labor drives expenses for the City's current base budget at a pace faster than increase to revenues
- Available reserves would be exhausted within 3 years due to General Fund structural budget deficits if the current spending and revenue patterns continue
- Current and projected real estate conditions as well as Measure A limitations on residential construction will result in property tax remaining static during the next 3 years

- Sales tax will have limited growth potential reflecting only changes in general economic conditions and not significant new sales tax producing sites within Tracy during this period
- The current real estate environment and related mortgage issues and foreclosures are serious and the full effect of this environment on the nation's economy and the local economy is unknown but could be far reaching with lingering implications

Short Term Fiscal Strategies for Remainder of FY 07-08 and FY 08-09: These will guide the upcoming FY 08-09 budget formation:

- A focus on maintaining existing service levels
- No new programs, expansion of existing programs or new full time staffing will be added unless a corresponding reduction is made in another service.
- Recognize historical spending averages (including personnel vacancies) and related budget savings
- Authorize the City Manager to manage budgeted personnel resources on a case by case basis (i.e. vacant, unfilled, future vacancy, etc.) for non-public safety positions.
- Public safety positions will continue to be recruited and filled.

With the implementation of the above short term strategy, it is estimated this will have a significant positive financial impact as demonstrated below.

Without implementing short term budget strategy measures:

	FY 08-09	FY 09-10	FY 10-11
Deficit	-$ 9,648,400	-$11,598,303	-$13,624,863
Ending E.U. Fund Bal.	$ 3,651,600	$0	$0
Ending G.F. Bal	$18,951,780	$11,005,077	-$ 2,619,786

With implementing short term budget strategy measures:

	FY 08-09	FY 09-10	FY 10-11
Deficit (estimated/actual)	$ 5,748,530-	$ 7,519,908-	$ 9,304,688-
Ending E.U. Fund Bal.	$ 7,551,470	$ 31,562	$0
Ending G.F. Bal	$18,951,780	$18,951,780	$ 9,678,654

Long Term Strategy: In addition to short term measures, staff recommends that an internal budget committee be established, made up of interdepartmental staff representatives, working with a consultant, to examine ways to address the structural budget deficit. This committee would consider the following:

- Revenue strategies, including pursuing a variety of fee studies (some have already been commenced) to insure cost recovery where appropriate
- Examine current service delivery models in an effort to create greater efficiencies and alternatives

- Review high cost, low participatory (i.e. attendance or fee paying) programming throughout City services and adjust if necessary
- Review upcoming capital improvement projects to make sure future operating costs are covered
- Review expenditure controls and possible shifts between funds
- Utilize the Reserve for Economic Uncertainty Fund first to assist in bridging financial challenges during a 3 year period and minimize the impact on the General Fund Reserve.
- Establish a minimum General Fund Reserve goal.

It is anticipated that Staff will return to City Council in October 2008 with a detailed report on long term strategies to address the General Fund structural budget deficit. Long term actions will be necessary not only to address the General Fund structural budget deficit but also in order to address new community needs such as public safety.

FISCAL IMPACT

It is estimated the City will spend approximately $6 million more from the General Fund than it receives in revenue during FY 07-08 even with a GASB 31 adjustment to investment earnings/values. These funds will come from the Reserve for Economic Uncertainty Fund. The short and long term strategies recommended will allow the City to develop a plan to address the structural deficit.

RECOMMENDATION

It is recommended the City Council accept this fiscal report and review the elements of a short term and long term fiscal strategy. Such a strategy will be placed on the regular City Council agenda for adoption.

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